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DEPARTMENT OF STATE REVENUE

LETTER(S) OF FINDINGS NUMBER(S):

99-0397, 99-0390, 99-0394, 99-0395, 99-0396, 99-0398, 99-0405

Adjusted Gross Income Tax For Tax Years 1994 through 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income—Foreign Sales Corporations Dividend Deduction

Authority: IC 6-3-2-12

Taxpayer protests the adjustment of the Foreign Sales Corporations dividend deduction.

II. Adjusted Gross Income—Business/Nonbusiness Income

Authority: The May Department Stores Company v. Indiana Dept. of Revenue, 749 N.E.2d 651 (Ind. Tax 2001); IC 6-3-1-20; 45 IAC 3.1-1-29 45 IAC 3.1-1-30

Taxpayer protests the classification of income from the sale of stock in a former subsidiary as business income.

III. Adjusted Gross Income—Business/Nonbusiness Income

Authority: The May Department Stores Company v. Indiana Dept. of Revenue, 749 N.E.2d 651 (Ind. Tax 2001); IC 6-3-1-20; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30

Taxpayer protests the classification of income from the sale of stock in a former subsidiary as business income.

IV. Tax Administration—Negligence Penalty

Authority: 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer operates several companies in the automotive supply industry and the energy supply industry. Taxpayer files a combined return with the State of Indiana. As the result of an audit, the Indiana Department of Revenue issued proposed assessments on taxpayer for the tax years in question. Taxpayer protests these assessments. Further facts will be supplied as needed.

I. Adjusted Gross Income—Foreign Sales Corporation Dividend Deduction

DISCUSSION

Taxpayer protests the Department's decision to adjust a deduction taken by taxpayer on dividends from Foreign Sales Corporations (FSC). The instructions on the return explained that the dividend deduction is allowable net of all related expenses and any attributable expenses from Federal Form 1118. The Department adjusted the dividend deduction to reflect that FSC sales commission expenses were a related expense.

Taxpayer refers to IC 6-3-2-12, which states in part:

- (a) As used in this section, the term "foreign source dividend" means a dividend from a foreign corporation. The term includes any amount that a taxpayer is required to include in its gross income for a taxable year under Section 951 of the Internal Revenue Code, but the term does not include any amount that is treated as a dividend under Section 78 of the Internal Revenue Code.
- (b) A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income.
 - (1) the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by
 - (2) the percentage prescribed in subsection (c),(d), or (e), as the case may be.

The aforementioned subsections (c), (d), and (e) allow corporate taxpayers to receive a one hundred percent (100%) deduction for foreign source dividends received from corporations in which a taxpayer has an eighty percent (80%) or larger ownership interest; an eighty-five percent (85%) deduction for dividends received from corporations in which a taxpayer has a fifty to seventy-nine percent (50%-79%) ownership interest; and a fifty percent (50%) deduction for dividends received from corporations in which a taxpayer has less than a fifty percent (50%) ownership interest. IC 6-3-2-2 (c)-(e).

This statutory language is cogent and clear. IC 6-3-2-12 authorizes pro rata deductions (based on the percentage ownership of the payor by the payee) of certain foreign source dividend income. In this instance, taxpayer has followed the statutory prescriptions in calculating its foreign source dividend deductions.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income—Business/Nonbusiness Income

DISCUSSION

Taxpayer protests the Department's classification of income from the sale of stock held in a former subsidiary as business income. Taxpayer claims that the income from the sale of this stock is non-business income since the stock was held for investment purposes only. The Department classified the income as business income since the stock represented taxpayer's holdings in a former subsidiary. The Department considered the sale of stock in the former subsidiary as the continuation of a transaction. Three years passed between the initial sale and the final disposition of the remaining stock.

Business income is defined by IC 6-3-1-20, which states:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

Taxpayer held less than ten percent (10%) of the subsidiary's stock for approximately three years after the initial spin-off. Taxpayer explains that no centralized management existed and, therefore, no functional integration or economies of scale could or did exist.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The court looks to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or nonbusiness income under the transactional test. These regulations state "... the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664. In the instant case, taxpayer is not in the business of selling entire subsidiaries, therefore under May the sale of stock does not meet the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The Court in May defined "integral" as part or constituent component necessary or essential to complete the whole. Id. at 664-5. The Court held that May's sale of one of its retailing division was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the Court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In the instant case, taxpayer's business is manufacturing automotive parts. Taxpayer's disposal of the former subsidiary's stock was not a part or constituent component necessary or essential to complete the whole of taxpayer's business. Therefore, the income is not business income under the functional test.

Taxpayer has provided sufficient documentation to establish that it did not continue to operate the former subsidiary as part of its regular trade or business. Taxpayer held less than 10% of the stock of the subsidiary. This is an insufficient amount for taxpayer to have exerted control over the former subsidiary. Also, taxpayer held the stock for approximately three years before final disposition. Taxpayer's sale of stock in the former subsidiary does not meet the transactional or functional test as described in May.

FINDING

Taxpayer's protest is sustained.

III. Adjusted Gross Income—Business/Nonbusiness Income

DISCUSSION

Taxpayer protests the Department's classification of income from the sale of stock held in a former subsidiary as business income. Taxpayer claims that the income from the sale of this stock is non-business income since the stock was held for investment purposes only. The Department classified the income as business income since the stock represented taxpayer's holdings in a former subsidiary. Business income is defined by IC 6-3-1-20, which states:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

Taxpayer explains that it held less than fourteen and a half percent (14.5%) of one former subsidiary's stock for approximately one year after the spin off. Taxpayer also states that no income, gain or loss was recognized by taxpayer on the initial 85.5% disposition.

The subsidiary was spun off in a tax-free transaction within the meaning of Internal Revenue Code Section 368 (a)(1)(D). The Department viewed the disposition of stock as business income from the continuation of a business transaction. As a condition of making the initial sale of stock a tax-free transaction, taxpayer was subject to an Internal Revenue Service order which had the effect of neutralizing potential control of the second subsidiary by taxpayer.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The court looks to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or nonbusiness income under the transactional test. These regulations state “. . . the critical element in determining whether income is ‘business income’ or ‘nonbusiness income’ is the identification of the transactions and activity which are the elements of a particular trade or business.” Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664. In the instant case, taxpayer is not in the business of selling entire subsidiaries, therefore under May the sale of stock does not meet the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The Court in May defined “integral” as part or constituent component necessary or essential to complete the whole. Id. at 664-5. The Court held that May's sale of one of its retailing division was not “necessary or essential” to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the Court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In the instant case, taxpayer's business is manufacturing automotive parts. Taxpayer's disposal of the former subsidiary's stock was not a part or constituent component necessary or essential to complete the whole of taxpayer's business. Therefore, the income is not business income under the functional test.

Taxpayer has provided sufficient documentation to establish that it did not continue to operate the former subsidiary as part of its regular trade or business. Taxpayer held less than 15% of the stock of the subsidiary. Also, taxpayer held the stock for approximately one year before final disposition. Taxpayer's sale of stock in the former subsidiary does not meet the transactional or functional test as described in May.

FINDING

Taxpayer's protest is sustained.

IV. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. The relevant regulation is 45 IAC 15-11-2(c), which states in part:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-2.1] if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer has demonstrated that it exercised ordinary business care and prudence in carrying out its duty to pay income tax. Therefore, taxpayer has affirmatively established reasonable cause, and the negligence penalty shall be waived.

FINDING

Taxpayer's protest is sustained.